

State of Michigan
Testimony of Rodger A. Kershner
Before the House Energy and Technology Committee
February 14, 2007

Good morning. My name is Rodger Kershner. Thank you for the opportunity to address problems and possible solutions in the Michigan electricity industry. I am an attorney with the firm of Howard & Howard Attorneys in Bloomfield Hills. Prior to joining the firm in 2003, I was Senior Vice President, General Counsel and Secretary of CMS Energy, the parent company of Consumers Energy.

For the past 18 months I have been advising LS Power and New Covert Generating Company in their effort to overcome the legal barriers to compete as wholesale producers and sellers of electricity in Michigan. As a part of that effort I have participated in the work of the PSC staff to lay the groundwork for the eventual production of Chairman Lark's report to the Governor and I have participated on the workgroups formed by Senator Patterson to study those same issues. I have the greatest admiration for the work of the PSC staff in assembling and analyzing the data contained in Chairman Lark's report. However, I am disappointed that the Chairman chose to recommend the policy option advanced by the utility companies, rather than the option drafted and supported by essentially all of the other participants in the 21st Century Energy Plan process. Chairman Lark has concluded that the solution to the very real possibility that Michigan will face electricity shortages is to eliminate competition in both the wholesale and the retail electricity markets and sole source the production of electricity to the utilities. In my view, that course would be both counterintuitive and counterproductive.

LS Power Development and New Covert Generating Company, together with a large group of other parties interested in addressing the apparent problems in Michigan's electric industry, have formulated a policy proposal for your consideration. Our group, the Customer Choice Coalition, has broad membership that includes the industrial group known as ABATE, the AARP, many schools, trade associations and consumers who now enjoy the benefits of competition or look forward to those benefits. Our proposal is designed to address the dual problems of the predicted shortage of electric generating capacity and the need to keep the cost of electricity as low as possible.

Under the present regulatory scheme, the large electric utility companies have been the beneficiaries of the power to decide when, whether and what kind of electric generating capacity will be built to serve their customers. Naturally, those decisions are made with a view toward the best interests of the utilities' shareholders. If we wish to have fundamental decisions about the State's electric infrastructure made in an environment where the best interests of all of the citizens of Michigan, and not just utility shareholders are considered, some statutory changes will be required.

The policies we advocate, if adopted by this body and ultimately enacted into law, would have the effect of both removing the barriers to entry into the Michigan wholesale electric market for companies like LS Power and New Covert Generating and introducing for the first time downward price pressure in the form of true competition in the wholesale electric market.

Our policy proposal is simply this. First, we would authorize and require the Public Service Commission to make the fundamental decisions about what generating and other electric infrastructure resources are required by Michigan's big electric utility companies based upon criteria that would include not only the welfare of those companies' shareholders but also the

general welfare of the people of this State. Those considerations would necessarily include providing the least cost electric power to our industries to enable them to remain or expand in Michigan and still be profitable. Second, we would require the Public Service Commission, whenever it determines that the large electric utilities do require additional resources, to design and require the utilities to employ a system of competitive bidding to acquire those resources, the cost of which is, after all, being directly passed through to the utilities' rate payers. The competitive bidding process, sometimes called a request for proposals, or RFP, process would be designed in such a way as to permit and promote fair head-to-head competition between all qualified providers, including the electric utilities themselves. It would provide a level playing field, would provide a process to be administered by a neutral expert party and would leave the ultimate decision to be made by the Public Service Commission. Sole sourcing would not be permitted.

Finally, in order that such a process not impose financial risk or hardship upon the electric utilities, who in our system are merely a no-markup conduit for power, we would guarantee that when resources are acquired by the utility companies in accordance with the procedure I just described, the process would serve as both a conclusive determination that the resources were needed and a conclusive determination that the utilities' financial commitment to obtain the resources is prudent. Recovery by the utilities of the amount they spend would therefore be guaranteed.

Our proposal is in contrast to the somewhat surprising conclusion and recommendations in Mr. Lark's report that competition in the wholesale electric market is not necessary. The 21st Century Electric Energy Plan advances 4 arguments in support of the Chairman's position, all 4

of which, on careful examination can be seen to be based upon false premises, faulty logic, or both.

First, the report argues that requiring a regulated utility to enter into a contract to purchase its power from an independent power producer “may be viewed as utility debt.” This is the so-called “imputed debt” argument. It is important to note at the outset that so-called imputed debt is not debt at all in any legal or accounting sense. It is merely an assessment by debt rating agencies that a utility could be subjected to financial risk if it was required to sign a long term Power Purchase Agreement and there was any substantial risk that the utility would not be allowed to recover payments made under that contract through its rates. Such a determination could lead to higher cost of a utility’s borrowing. Please recall that the third part of our policy formulation would guarantee recovery of those costs and, therefore, eliminate that risk altogether.

Chairman Lark cites the Electric Power Supply Association as the source of his concern over “imputed debt”. But that very same agency said in a comprehensive report in 2005, that the risk Chairman Lark cites may be discounted nearly to zero by the debt rating agencies under circumstances of guaranteed recovery like those that we propose in our policy formulation.¹ Page 39 of that report says “Finally, S&P [Standard & Poors] will assign a low risk factor of 10 to 20% for distribution utilities where cost recovery is legislated.” Legislated cost recovery is a key element of our policy proposal.

Second, the Lark report argues that if a utility builds a power plant with a useful life of, say 60 years and recovers its investment in the plant from ratepayers in, say 40 years, the ratepayers are enjoying the use of the plant for free for the last 20 years. This, the report says, is in contrast to a situation where the utility had signed a 40 year contract to buy the power from an

¹ Electric Power Supply Association: The Role of Competitive Procurement and Debt Equivalency, 2005.

independent producer, because when contract payments end, so would the supply of power. There are at least 2 fallacies in that argument.

To begin with, proper ratemaking would match to useful life of the plant with the period of recovery by the utility of its investment. The report's premise is that ratepayers would be paying too much in the early years so they could pay nothing in the later years. Second, the illustration would ask you to compare the cost per unit of electricity produced by the IPP and by the utility over different periods of time- 40 years for the IPP and 60 years for the utility; in other words, to compare apples to oranges. Finally, the report concludes that based upon these bad facts and bad logic, the utility must be a cheaper alternative. We say, instead of assuming we know who the winner will be, let's run the race and find out for sure. What is the harm?

Chairman Lark also suggests that introducing competitive bidding into utility procurement is unnecessary because the Public Service Commission could require utilities to solicit competitive bids for the construction of the plant in a Certificate of Need proceeding. The Lark report asserts that cost represented by a construction contract is 85% of the total cost to construct the plant. Regardless of whether this is factually accurate, the fact remains that Michigan's industries and residents are not purchasing a power plant, they are purchasing electricity, and whereas the construction contract price may represent 85% of the total construction cost of the plant, it actually represents a tiny fraction of the lifetime cost of producing electricity from the plant. To introduce competition into a tiny fraction of plant cost is, of course, progress. In fact, it would be alarming if a utility or anyone else even considered building a power plant without taking bids for the construction work. However, this tiny step toward introducing competition to the wholesale market is woefully inadequate.

Finally, the Lark report says, the utilities already have ample motivation to keep the cost of power generation to a minimum, because if their costs are too high, they will lose retail customers to alternative energy suppliers. That could have been a true statement, had the report not already suggested that utilities ought to be able to insulate themselves against the migration of customers by applying for and receiving a Certificate of Need from the PSC. Anyway, we all need to keep in mind that utilities earnings, and therefore their motivation, are not directly dependent upon how many customers the utility has, but they *are* directly dependent upon how much capital the utility has invested in power plants. Utilities are fundamentally motivated by duty to their shareholders to build more expensive, not less expensive, power plants.

Utilities buy or make power as the agent of their customers. Most of those customers, especially the big industrial customers, insist on using competitive bidding when they buy raw materials for their own account. But we have concluded that when the utility companies – with an obvious financial bias – buy power on behalf of those customers, competition goes out the window and sole sourcing of supplies is perfectly acceptable. It should be clear that the failure to create a functioning RFP system to supply needed resources to utility customers will harm those customers. What is less obvious is that the lack of competition to supply the big utilities may also harm industrial and other customers not served by those utilities.

To encourage wholesale electric competition is also to assist retail competition. If we abandon the wholesale production of electricity to the electric utilities, potential retail competitors of those utilities have few sources of power with which to compete. Imperfect wholesale competition, therefore, compounds the imperfect retail market that we are all hoping to fix.

In my opinion think the key to opening wholesale and retail competition in electricity and holding down electric costs for all customers is in requiring the large investor-owned utilities, those which serve the greatest number of customers in Michigan, to procure the power intended for sale to their customers in the competitive wholesale market.

LS Power Development and New Covert Generating Company, as you have heard, are each in the business of generating electricity for sale at wholesale. Each is already competing in the wholesale electricity markets in states across the United States and regularly proving through RFP processes that they can produce electricity more cheaply than regulated utility companies. Each owns under-utilized assets in Michigan and each has expressed a desire to make further investments in Michigan if the circumstances permit.

We respectfully request that you answer the cry from Michigan households, businesses and industries for cheap, reliable power by renouncing the suggestion the sole-sourcing is a sensible procurement policy and embracing competition as the solution. Thank you. Mr. Chairman we are available to answer questions.